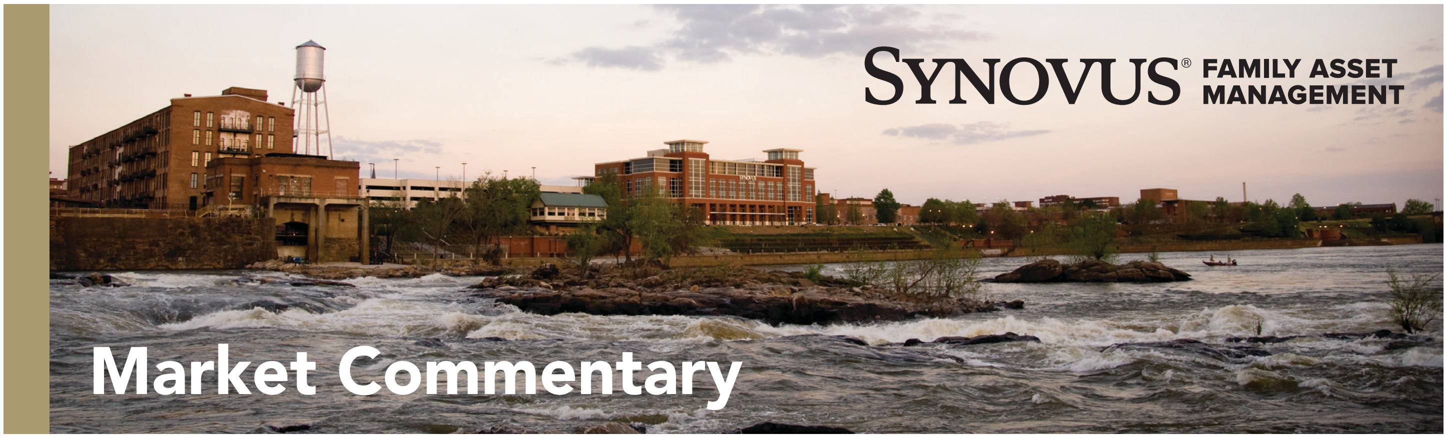


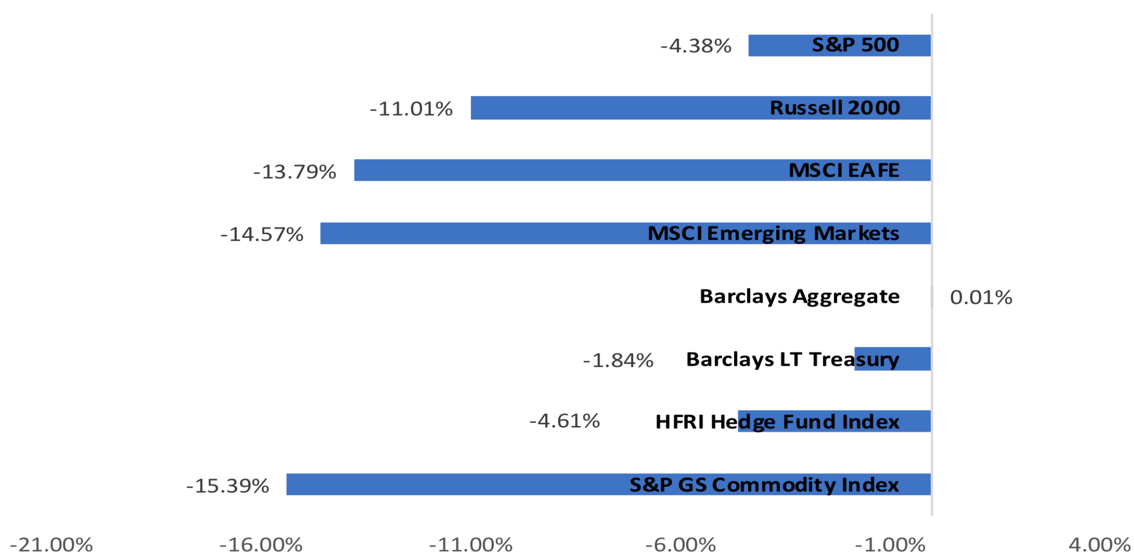
Market & Economic Review | First Quarter 2019

Q4 2018 Review

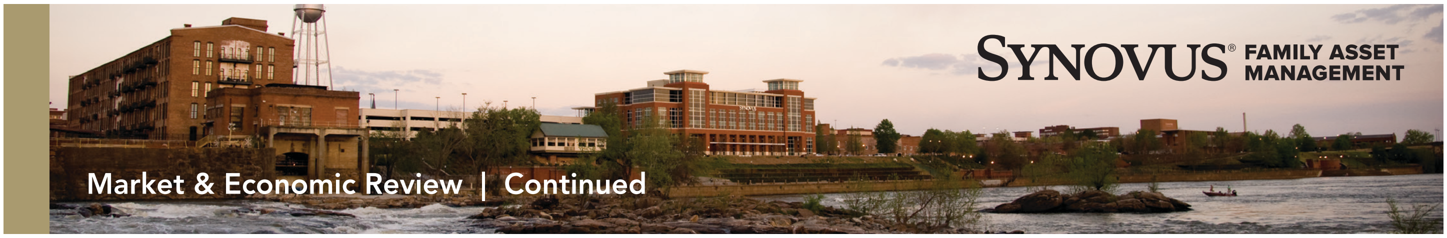
The fourth quarter saw a return to risk-off behavior by investors as equity indexes were down across the board. Gold and U.S. Treasuries were the few bright spots with U.S. stocks experiencing the drawdown that international stocks had experienced earlier in the year. The S&P 500 experienced a 20% intra-year drawdown for the first time since 2009. This drawdown bottomed out on Christmas Eve, making it the worst on record. It was, however, followed by the best day-after-Christmas on record. The realization of slower global growth and continued uncertainty with government shutdowns and tariffs were primary triggers for the selloff.

The outlook for interest rates went from one where it looked like the Fed would continue to raise rates in 2019 to an outlook that they would not be able to raise rates much more without pushing the economy into a recession. This realization stemmed from the continued slowing of China's economic growth, tepid growth in Europe, and the likelihood of U.S. GDP growing at around 2% going forward. While most investors have focused on the Fed Funds rate, fewer have paid attention to the shrinking of the Federal Reserve's balance sheet. In addition to raising short term rates, the Fed can also tighten credit by shrinking their balance sheet. These factors have investors questioning if the U.S. economy can withstand more tightening.

Asset Class Returns 2018



Source: NDR



Equities

U.S. stocks had been in a unique position in relation to other developed equity markets prior to the end of the year. With the announcement of tariffs, most export oriented markets had seen significant declines in their equity markets back in the second quarter. The U.S. was still benefiting from tax policy changes and strong consumer confidence. That all changed during the fourth quarter. The U.S. led most major markets to the downside with the S&P 500 and Russell 2000 down more than both developed international and emerging market indices. For the year, the S&P 500 finished down 4.38%, with the MSCI EAFE down 13.79% and MSCI Emerging Markets down 14.57%. Historically, with the drawdown we experienced at the end of the year, we would normally see value stocks outperform growth stocks. However, value stocks underperformed, and a major reason was tax loss harvesting. 2018 provided an opportunity for investors to realize a significant amount of losses in their portfolio for the first time in several years. The stocks that tended to have losses were value stocks and small cap stocks. At the market close on Christmas Eve, many value and small cap stocks were down 20% - 30% for the quarter. Yet, the day after Christmas the same stocks were some of the biggest gainers. We are likely to see some momentum of value and small cap stocks playing catch up through the beginning of the year.

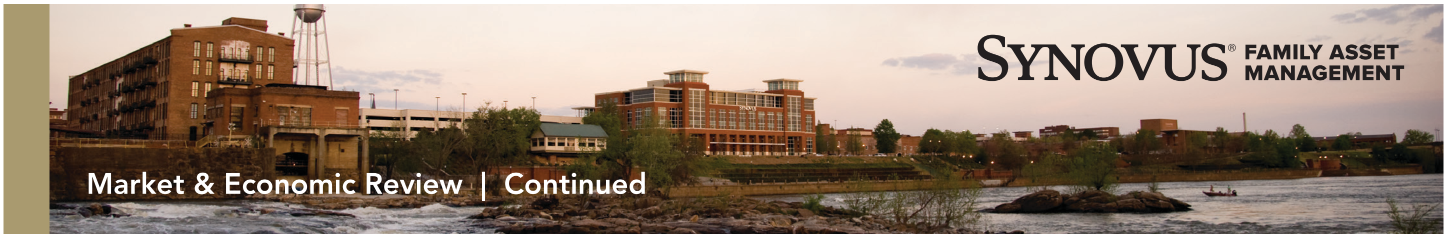
On a go forward basis, the S&P 500 ended the year with a forward P/E ratio of 14.5x versus nearly 18.5x during the 3rd quarter. This puts the ratio below the long-term average of 16x, but it is also dependent on earnings growth coming in at 5%, on top of 2018's 20% increase in earnings. Measured against the Shiller P/E (10yr average earnings), the S&P is at, or slightly above, fair value. International markets continue trading at a bigger discount to historical averages and relative to the U.S., but the uncertainty of Brexit and tariffs justifies the discount. When both get resolved we will likely see a rebound in international indices relative to the U.S.

Fixed Income

The 10-year U.S. Treasury Bond started the year at a 2.4% yield, peaked at 3.24% in November, and ended the year at 2.56%. The increase in yield was due in part to the likelihood of continued rate hikes by the Federal Reserve and the concern that labor markets were tight enough to push inflation higher. Markets soon realized late in the year that tightening by the Fed had gone a long way, and considering the slowdown in China and Europe, it became apparent that the risk of overtightening was more imminent than being too slow to raise rates. The expectations for the number of rate hikes in 2019 went from around 4 increases of 25 basis points to 1 or 2 increases by the end of the year. We see the most likely scenario of no more increases to one additional increase as the likely path for 2019.

While many investors and strategists are concerned that inflation will get out of control if the Fed stops raising rates, we feel that there is still structural damage from the last recession that needs to be fixed first. The number of potential workers in the workforce took a major hit and has been steadily rebounding. It is likely that the unemployment rate can stay lower for longer without significantly heating up wage growth. Income inequality has been exasperated since 2008. The low interest rate environment has allowed for asset owners and employees in the technology sector to see tremendous gains while most other employees saw little increase. In the past year, we have seen overall wages increase by about 3%, while earnings for households in the bottom decile have seen gains of over 4.5%. Allowing for more wage growth before overtightening and moderating the economy will significantly repair the damage from the previous financial crises.

If the Fed is holds rates and wage growth picks up, we are likely to see a growing economy but declining corporate profit margins. The correlation between GDP growth and stock market performance is historically weak. We are likely to see moderate growth in the U.S. with more volatility in equity markets. This scenario makes it important to own true bonds in your portfolio. True bonds (Treasuries, municipals, and investment grade corporate) are those that can provide diversification



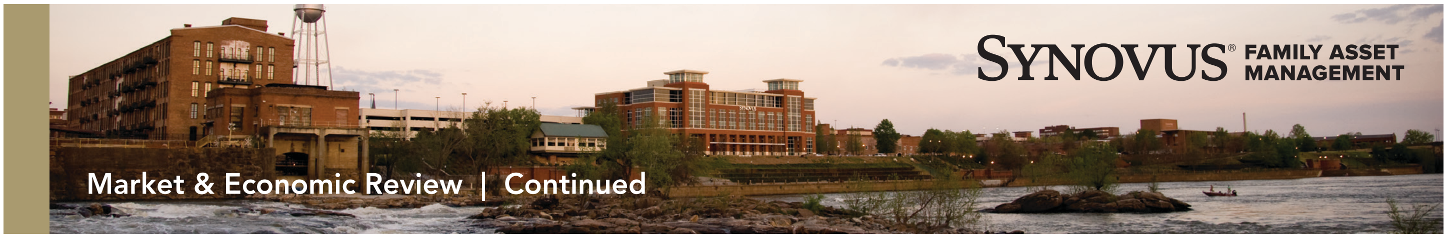
in scenarios where equities tend to do poorly. An environment of zero to negative inflation is an environment where owning true bonds is beneficial. An example of a non-true bond is one where performance moves down as equities move down. We continue to see investors avoid quality bonds while chasing yield. High yield, emerging market debt and structured notes are a few examples we continue to see. What investors don't realize is that there is always a price to pay for reaching for yield U.S. Treasury, and municipal bonds. We see the most vulnerability in those areas that have higher correlations to equity markets. High yield and emerging market debt have attractive yields, but behave more like equities when markets turn down. While the lure of higher yield is appealing, it can be a determent to portfolio diversification when it is really needed.

Going Forward

Global economic growth is slowing but still growing. We are likely to see the U.S. continue to grow but at a more moderate pace. Slower growth and the uncertainty around tariffs, Brexit, and the shrinking of the Fed's balance sheet will keep interest rates lower for a longer period of time. The Federal Reserve is likely going to pause during the first half of the year with a possibility of one more hike. If the Fed stays put on rates, and a trade deal with China can be worked out, we will continue to see improvement in wages on the lower end and a consumer that is in relatively good shape. The corporate space is where we see the potential for disruption that could lead to a potential run of the mill recession. Leverage has increased significantly and many firms are dependent on interest rates staying low. Our long-term thesis is to stay with quality investments, as there will be a divergence between the strong and the weak. While we do not foresee a recession in 2019, it is likely that when it happens it will be more like a 1991 or 2001 type recession where there will be investments that will make positive returns. In 2001, for example, small cap stocks and value stocks were higher when the S&P 500 was down double digits. Many hedge fund strategies made money in 2001 and diversification away from large cap growth stocks worked. We continue to push for diversification in building out an optimal portfolio for clients to achieve their long-term goals.

In 2018, we saw absolute return hedge fund strategies perform how we would expect them to. Outside of long/short strategies, we saw hedge funds beat both equity and bond indices during the year. Long/short continued to be a disappointment as most managers are long small cap and value and short large cap and growth stocks. Private equity continues to be an area that many investors are flocking to. We are seeing large funds continue to pay up for deals and are finding ways for smaller and smaller investors to participate. Our approach is to avoid these managers and focus on smaller niche players who are disciplined in what they will pay for a business. The size of the private equity market has continued to grow, but based on how technology based companies are financed, it makes sense that the market should be getting larger. Many of the innovative companies are reliant on equity as they have very little tangible assets that are bankable in the traditional sense. Private equity is the funding source that pushes growth in innovation and many small firms are deciding to stay private longer. Co-investments have become a piece of our private equity approach, but we are cautious there as well. There is no shortage of opportunities but there is a shortage of good opportunities. We see deals every day that are unsolicited. Our approach is to seek out partners and invest in the opportunities where we are comfortable with the lead investor and not to be a "taker of random deals" where we are likely to be the last in a line of investors who passed on it.

In this part of the cycle it is as much about knowing what not to invest in as it is about what to invest in. We are amazed at the number of products that are being pitched that have no purpose in a long-term investment portfolio – ones that will likely do the opposite of what an investor thinks they will do. The only certainty is that those pitching them will have pocketed a significant fee, while the investor will be left wondering exactly what they invested in. Most investors are concerned about interest rates going higher and the market seeing a 2008-like decline. Wall Street is aware of those behavioral biases and is happy to pitch a product that will weave a story around curing those concerns. A few examples include short volatility strategies and structured notes that are equity/credit risk disguised as fixed income. We enjoy digging into these structures and finding the hidden risks and fees, so please forward any on to your relationship manager or the investment team.



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